CRISIL Young Thought Leader 2008

A DISSERTATION ON

ISLAMIC BANKING IN INDIA
-a study of future potential

Post Graduate Category

Word Count of Dissertation: 2500 excluding cover page and profile

Word Count of Profile: 460

25-Oct-08

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EXECUTIVE SUMMARY

Islamic Banking is system of Banking consistent with Shariah laws, which is against the collection or payment of taxes. According to Islam, interest leads to inflation, and accumulation of interest leads to increasing the divide amongst the rich and poor. In an Islamic mortgage transaction, instead of loaning the buyer money to purchase the item, a bank might buy the item itself from the seller, and re-sell it to the buyer at a profit, while allowing the buyer to pay the bank in installments.

Islamic Banking has a huge market potential in India as India is the 3rd largest Muslim populated country in the world. It can address the long drawn issue of 'Financial inclusion' and will create a *feel good* factor among Muslims. Muslims would come out of 'isolation' and it can be used as a facilitating tool to combat terrorism in few states of India. Indian government can gain diplomatic advantages to make financial dealings with Muslim dominated nations and can attract equity finance from gulf countries for infrastructure development, thereby financing the fiscal deficit.

There exist significant challenges to materialize the objective of expansion of Islamic Banking in India. Lack of experts in this field leads to differences in interpretation and compliance with Shariah laws. Moreover in case of India, Banking regulation Act of 1949 needs to be suitably modified to introduce Islamic Banking. New Standard Accounting practices have to be developed. Islamic Banking *per say* goes against the secular framework of our nation and can create financial segregation. It can also be exploited politically, so it has to be seen in the right light.

There is a need to customize and advertise Islamic banking to make it equally attractive to Non-Muslims. The product trends are positive in India and given the double digit growth of Islamic Banking in other Asian countries like Asia and Singapore, it is definitely a viable option for India.

INTRODUCTION

Islamic Banking refers to a system of banking that is consistent with Islamic law (*Sharia*) known as *Fiqh al-Muamalat*, and is guided by Islamic economics. Islamic law prohibits usury, which is the collection and payment of interest, commonly called '*Riba'*. Islamic law also prohibits investing in businesses that are considered unlawful or '*Haraam*' (such as alcohol, gossip columns or pornography).

Financing options include

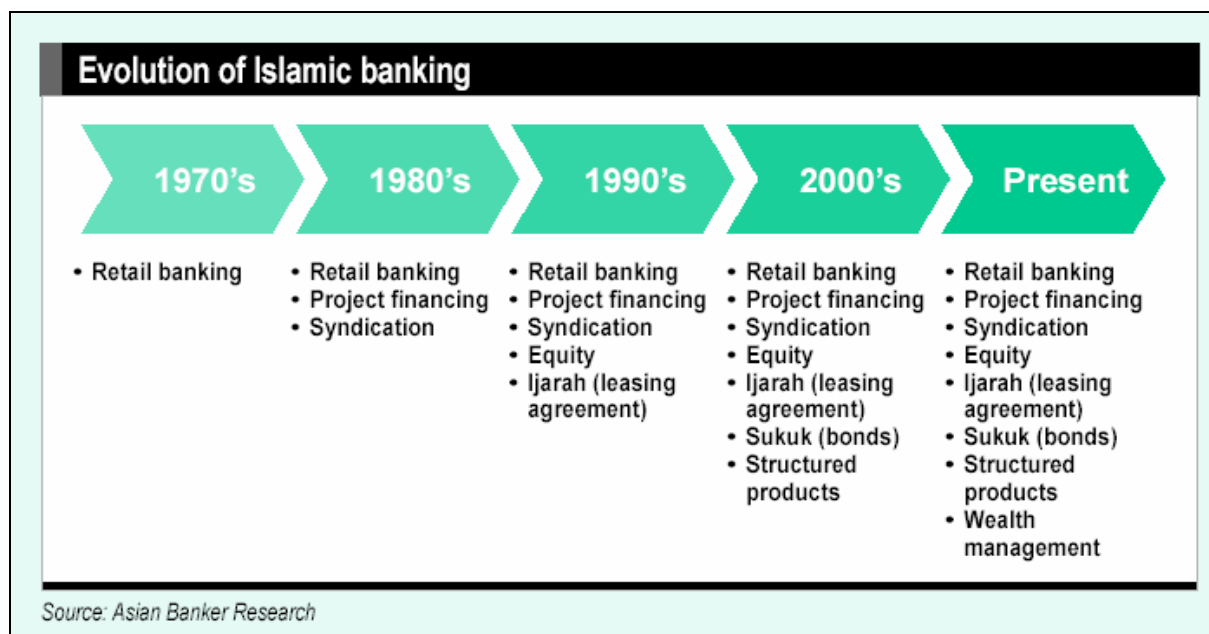
- Murabaha → Cost Plus Financing
- Ijara → Leasing
- Istisna'a → Construction Financing
- Mudaraba → Profit Sharing
- Musharaka → Joint Ventures
- Al Rahn → Short Term Financing
- Salam → Forward Purchasing
- Kafala → Guarantees
- Qarhd → Non Profit Loans

In the book, the **'Future of Money'** by Bernard Lietar, he expertly highlights the intrinsic dangers of 'interest' and then mentions how Islam has admirably represented the last bastion of resistance. He illustrates how interest is a direct cause of inflation, wealth imbalance contributing to the rich getting richer and the poor getting poorer.

BRIEF HISTORY

Although Islamic Banking can be traced backed to 8th Century in Muslim countries, modern Islamic Banking started in Egypt in 1963 by Ahmad EL Najjar. In 1975, the **Islamic Development Bank** was set-up with the objective to provide funding of projects in the member countries. The first modern commercial Islamic Bank, **Dubai Islamic Bank**, opened its doors in 1975.

With presence in over 60 countries and a 15% CAGR, it has estimated designated assets worth $1.3 trillion in more than 400 financial institutions offering Shariah compliant products. **Saudi Arabia's Al Rajhi** is the world's biggest Islamic Bank by assets, which stand at $28 billion.

Source: Asian Banker Research

FUTURE POTENTIAL OF ISLAMIC BANKING IN INDIA

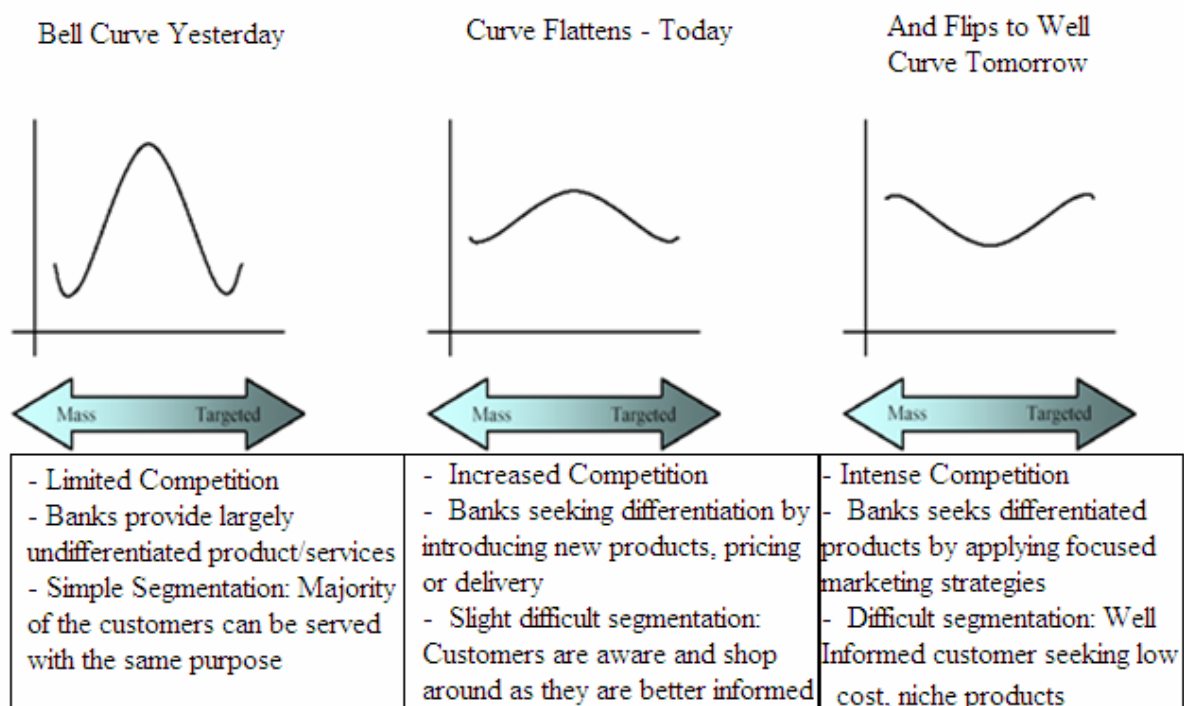
The current Muslim population of the world is 1.8bn and Muslims are about 13.4% of total population of India, approximately 152mn as per CIA.

Given the above mentioned statistics, it becomes imperative to introduce this form of Banking in India as there exist wide disparity in terms of regions, religions, languages etc. This disparity provides us with a *Blue Ocean* which can be exploited to make a positive mark on the banking landscape of our country. It would help to increase the size of the banking industry manifold and prove to be a foundation for many more innovations to be introduced in future.

The Sachar Committee report highlighted that approximately 50% Muslims are financially excluded. The long held issue of financial inclusion can be taken care of by introducing Islamic Banking. Majority of Indian Muslims are so poor that they are not targeted by the Commercial Banks and whose savings lie idle at home. Muslims in India generally lack creditworthiness primarily because they form part of "Ghettos" or negative areas, which were drawn back and are still in vogue. It is here where the actual market potential of Islamic Baking lies.

One may argue that Indian Muslims are satisfactorily using the existing Conventional Banking system. A *one to one interview* with Bank executives of Personal banking division of many Banks revealed that a significant Muslim population is:

1. Not investing in mutual funds with a debt component
2. Donating the interest on their salary savings account to charity
3. Using a zero-interest current account instead of a savings account

The above steps are diligent efforts made by many Indian Muslims to make the current conventional Banking 'Shariah' compliant in their own way. This is the huge market which can be tapped by Islamic Banking.

The above figure shows as the markets grow, more niche products are sought after, and therefore Islamic banking could become a *new buzzword*.

World over, the Monetary Authority of Singapore has made the development of Islamic finance as one of its priorities and has accordingly aligned tax policies. Malaysia has pioneered the art of Islamic Banking. There are currently 11 banks operating on a full Islamic banking license in Malaysia and eight others that offer Islamic banking products through a conventional bank window. Malaysian banks dominated the top ten in The Asian Banker's 2007 "Top 40 Islamic Banks in Asia Pacific" report. Even China has opted for Islamic banking to pool Islamic Investment Funds. This proves the potential of Islamic Banks and definitely India needs to taste this as well. Islamic Investment business is gaining considerable grounds and companies like

McKinsey & Company Inc. and Bearys Group have started doing big businesses through Shariah Investments funds. 'East wind' launched Islamic Index; and 'Reliance Money' and 'Religare' have launched Shariah Complaint Portfolio Management Services. As a result Indian Stock market is also observing some better trends in Shariah complaint stocks.

According to Sabry Ghouse, head of retail banking at Al Rajhi in Malaysia, non-Muslim customers now make up a sizeable proportion of the entire customer base. "We opened a branch in Puchong, a suburb in Kuala Lumpur, to specifically target the non-Muslim market," he says. Angelo Vernados, author of Islamic Banking and Finance in Southeast Asia: Its Development and Future, estimates that 75 percent of products sold by Maybank and OCBC Malaysia are to non-Muslims. ***"It's not just about Muslim investors,"*** he says.

STRENGTHS

- 13.4 % population of India are Muslims
- Bridges the rising Income disparity in India
- Demand for niche products is increasing in India
- In comparison to recent economic turmoil, Islamic banking products which are comparatively safer

WEAKNESSES

- Lack of experts
- Modification in Banking Act Regulation needed
- Existing prejudices (Sinha' Comm report)
- Differences in Islamic ideology on Shariah

OPPORTUNITIES

- India economy would benefit from inflow of funds from GCC countries
- Would add to real estate boom
- Addresses the issue of Financial Inclusion
- A large number of Muslims that are considered unworthy of credit by Commercial Banks or who avoid banks due to Sharia laws would welcome this

THREATS

- Could become a political weapon
- Goes against secular fabric of nation
- May brings financial segregation, so regulatory authorities may oppose.
- Microfinance is a good Competitor

CONTRIBUTION TO INDIA'S GROWTH AND WELL BEING

The rising Income Inequality in India is a cause of concern with World Income Inequality Database (WIID) and the UN Human Development Reports stating it to be 36.8, quite close to World Average and indicating it to have a rising trend. This wide Income Inequality in its extreme voracious forms has lead to spread of Terrorism. As Muslims who follow Shariah laws do not avail credits, and remain isolated, Islamic Banking would help a lot in their upliftment. Seen in this light, in the long run it could become a major tool to combat Terrorism.

With the introduction of Islamic Banking, Indian government will gain diplomatic advantages to make financial dealings with Muslim dominated nations especially to attract trillion dollars of equity finance from gulf countries.

The total investment in Infrastructure is expected to be Rs 20,56,150 crore for the 11th five year plan. Of which Rs. 14,36,559 crores are supposed to be met from Public Investment and Rs. 6,19,591 from private investments. The GCC countries interest in Venture Capitalism and real estate financing can help in infrastructure development in India

A rough estimate shows that introduction of Islamic Banking and development of Islamic Funds would lead to adding of approximately 6mn new DEMAT accounts, thereby giving a boost the Share Market. In line with Dow Jones' Islamic index, a similar index on BSE or NSE will attract funds from those Muslims who want 'financially rewarding Shariah compliant investments'.

The inadequate capital investment in unorganized sector can receive a boast through equity finance of Islamic banking. This sector normally lack collateral, hence are not eligible for debt financing. Islamic banking is tailor made for this situation and thus can lead to the next revolution in agriculture and unorganized sector.

Last but not the least; it would bring a feel good factor for Muslims whose sentiments are a lot hurt after the recent Terrorist attacks.

As per the SWOT Analysis of Islamic Banking done above, it is clear that it faces many challenges in India. Banks will have to come out of Religious set up and offer products of wider spectrum to a wider audience. It's a challenge to provide a solution that adheres to the basics of the Islamic finance concept and at the same time remains flexible enough to meet the demands of the changing environment. There is a need to advertise Islamic Banking so that it could be used by Non- Muslims as well.

Porter's Five Forces model analysis shows:

Bargaining power of Customers: High

- The staunch Muslim Customers may accept things in name of religion but the liberals would go in for better returns. India's Banking system offers wide range of products to please customers and is highly competitive.

Competitive rivalry within Industry: Moderate

- Conventional banking format has wider options to raise funds, deploy it globally, and hence have cost advantage.
- Micro finance institutions

Bargaining power of Suppliers: Low

- There is a lack of expert staff but Indian Muslims would definitely enter this industry.

Threat of substitute products: Moderate

- Micro Finance is another good option

Threat of new entrants: Low

- This is a highly niche product till it is customized for Non-Muslims, so there are few new entrants.

IT application has to be strengthened for supporting such a complex business model. All major IT providers like TCS, Infosys etc do provide such solutions to overseas clients, but keeping in mind the strong Regulatory framework of India, IT process will have to be customized.

Islamic banking experts will have to be brought in and a 'standard' accounting and auditing practice across geographies will have to be introduced and therefore, there exists a need for improvement of corporate governance and risk management.

Due to scholastic differences within Islam, there exist different interpretations on the definition of a product being Shariah compliant. The five teachings, '*Shafii'*, '*Shia'*, '*Hanafi'*, '*Hanbali'* and '*Maliki'*, all have subtle differences. There have been many standardization initiatives, one of which is initiated by the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI). The Islamic Financial Services Board is also working to create common financial reporting standards for Islamic banks.

There are several other areas that Islamic banks need to strengthen, ranging from IAS39 based classification and provisioning to SOX compliance and KYC norms.

In the face of the global banking crisis emanating out of subprime mortgage financing, there will be greater pressure on banking formats like Islamic finance to propagate them by creating a positive perception among customers while ensuring adequate and effective risk management Mechanisms. Though much work is being done, it's still not known clearly how Basel II will affect Islamic banks and how exactly risk capital will be derived for better risk management.

PRODUCTS TRENDS

'Musharakah' or participatory finance will be perceived as a safe means of finance, with more banks getting into ownership mode. Islamic financing concepts like '*Ijarah'*, '*Tawarruq'* and '*Murabaha'* will grow with inbuilt features like known future cash flow, to provide customers with comfort of financial planning. Floating rate based Ijarah and other finance products can help customers to take advantage of floating financing options.

The secondary market for fixed return investments like that of *Sukuks* is expected to grow – they have already experienced huge momentum in recent years. It is a fixed income instrument similar to 'bonds' can be treated as 'asset backed security'. Today market for *Sukuks* stands at around USD 70 billion worldwide, with large corporate houses presenting their own *Sukuk* issuance plans in Malaysia and the UAE.

WORKING MODEL OF ISLAMIC BANKING IN INDIA

A Shariah Supervisory Board will have to monitor the activities of the Islamic Banks. The funds from Islamic Banking will have earmarked separately, thereby allowing better transparency. As a working model, Islamic banks may operate under any of the following two structures:

1. **The Two-Windows Approach**

This approach emphasizes on classification of deposits and therefore is divided into two sections: one for 'Chequing' and the other investments option being left to the client. Current deposits are guaranteed by the bank, being held in trust and are repayable in full on demand. This type of deposit earns no revenue by virtue of its availability.

2. **The Two-Tier Approach**

The two-tier approach offers a wider array of investment options with the intent to attract customer whose main objective is growth and income options. It can be preferred by specialized investment firms and wealth management consultancies offering expertise and investment vehicles to mobilize surplus funds.

CONCLUSION

Islamic Banking has good prospects in India, given the diverse Indian canvas and holds good for India from a development point of view. It is presently faces many challenges that needs to be addressed. This requires a dedicated effort of a strong committee which can take a unbiased stand, both from economic and secular perspective and recommend changes to be brought in 'Banking Regulation Act' for introduction of Islamic Banking in India.

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AUTHOR'S PROFILE

Name: Pawandeep

MBA Specialsation: Finance and Operations
Work Experience: 36 months

EDUCATIONAL QUALIFICATION

2007-2009: PGDM, T. A. Pai Management Institute, Manipal – 7th Rank
2000-2004: B.E in Production Engineering from B.I.T. Sindri, Dhanbad, Jharkhand - 85.4% - 1st Rank
1999-2000: AISSCE – Science (PCM), CBSE, Jamshedpur Public School – 88.0% - 1st Rank
1997-1998: AISSE, CBSE, D.A.V Public School, Jhinkpani – 79.4% - 3rd Rank

INDUSTRY EXPERIENCE

Angel Broking — ***Summer Intern*** — ***Apr'08 – Jun'08***

- Project Title: 'Role of Quantitative methods for Portfolio Management in long term stock picking' – The project is a Finalist in *ARISTOS* best Summer Projects contest at NIILM, New Delhi

Hindustan Zinc Ltd - Vedanta Resources PLC — ***Engineer*** — ***Jun'04– Jun'07***

- Part of Team for Erection & Commissioning of 17000TPA Zinc Smelter at Chittorgarh, Rajasthan
- Part of Corporate Finance team for deciding investments to new Projects, financial viability of up-coming projects, Market Analysis for diversification etc
- Formulation of Business/Financial Plan, financial projections, audit and MIS for SBU's of HZL

TATA MOTORS — ***Summer Intern*** — ***May' 03- Jun'03***

- Project Title: 'Identification and elimination of sources of Quality Problems in Long Members'

CERTIFICATIONS

- NSE-NCFM certification in Financial markets, Securities markets and Derivatives markets modules
- Undergone 'Management Development programme' on Corporate Finance at IMI Delhi
- Undertook 'Executive Development Programme' at ISM Dhanbad
- Undertook *Six Sigma* Training for Green Belt and Black Belt from WIPRO

AWARDS AND ACHEIVEMENTS

- **1st Rank** in all 4 years of Engineering - Winner of '*Despande-Atkinson*' Merit Scholarship(4 years)
- Winner – 9th position in ***Brain of Bihar Contest,*** a state Level Contest
- **7th Rank** in **PGDM** course of T. A. Pai Management Institute, Manipal
- Winner of '*ACC Diamond Jubilee Merit Scholarship*' for academic excellence in standard X & XII
- Secured - 4th position in 'Fresher of the Year Contest' held in B.I.T Sindri
- 1st position in 'On The Spot Software Competition' held in B.I.T. Sindri
- Finalist in competition on 'Internet Awareness and HTML' by TISCO and Massachusetts Institute of Technology, USA

EXTRA CURRICULAR ACTIVITIES

- Held the post of *Secretary(2002-03)* of *LEO CLUB OF SINDRI,* a youth wing of *LIONS CLUB*
- Member of *Sponsorship Committee* of TAPMI's Inter B-School College Fest, *Atharva* for 2 years
- Member of *Leader Support Group* at *BrandScan-08,* involving market research

PROJECTS / RESEARCHS UNDERTAKEN

- Study on Development and Growth of Credit Derivatives market in India
- Analysis of pros and cons of proposal to abolish SLR requirement in India
- Impact of Derivatives upon the efficiency and liquidity of underlying assets

PERSONAL INFORMATION

Age:	25 years
Interests:	Photography, Skating, Internet Surfing
Languages Known:	English, Hindi, Punjabi